COMMONWEALTH OF KENTUCKY

BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

RATE ADJUSTMENT OF WESTERN KENTUCKY GAS COMPANY	))	CASE NO. 90-013

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O R D E R

On February 13, 1990, Western Kentucky Gas Company ("Western") filed its notice with this Commission requesting authority to adjust its rates for gas service on and after March 15, 1990. The rates proposed by Western would produce additional annual revenues of $8,972,531, representing an increase of approximately 8 percent. In order to determine the reasonableness of Western's requested increase, the Commission suspended the proposed rates and charges until August 15, 1990.

Motions to intervene in this proceeding were filed by the Kentucky Industrial Utility Customers ("KIUC"), Kentucky Legal Services ("KLS"), National Southwire Aluminum ("Southwire"), Logan Aluminum ("Logan"), and the Attorney General by and through his Utility and Rate Intervention Division ("AG"), and Mr. Everett Brawner, a customer of Western. All were granted. A public hearing was held in the Commission's offices in Frankfort, Kentucky, on June 20-22 and June 27-28, 1990. Simultaneous briefs were filed by August 8, 1990 and simultaneous reply briefs were filed by August 15, 1990.

This Order addresses the Commission's findings and determinations with regard to Western's revenue requirements and rate design and establishes rates and charges that will produce additional annual revenues of $1,018,455 an increase of 1.0 percent over normalized test period revenues.

NET INVESTMENT RATE BASE

Western proposed a net investment rate base of $81,627,268. Western's proposed rate base includes a plant acquisition adjustment in the amount of $4,119,284 as well as a revalution of working gas storage.[1]

PLANT ACQUISITION ADJUSTMENT/DEFERRED INCOME TAXES

In November 1987, the assets of Western were acquired from Texas American Energy Corporation ("TAE"). TAE had operated Western Since 1980 as a division of its diversified gas and oil exploration and production, and natural gas distribution company. As negotiations unfolded in mid to late 1987 for the purchase, Atmos Energy Corporation, formerly Energas Company, ("Atmos") was one of the five finalists and ultimately the successful bidder for the acquisition of Western. Atmos focused all of its attention toward acquiring Western's assets, rather than the stock. However, just prior to the transfer, TAE reorganized Western as a subsidiary and consummated the sale as a stock sale. Western stated in testimony in this proceeding that the primary reason for Atmos' desire to acquire the assets from TAE was the assurance of

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1 Exhibit 6, page 4.

the specific assets it was acquiring and, more importantly, the liabilities it was assuming. Atmos was particularly concerned that since TAE was in a poor financial condition and subject to bankruptcy, that it would not subject itself to liability for any other obligations of TAE. Atmos also wanted to handle the transfer as an asset purchase in order to receive the tax benefits resulting from the increase in the cost basis of the depreciable assets for tax purposes.

The transfer of Western in 1987 had two very significant impacts on the financial statements of Western which affect the revenue requirements as determined for rate-making purposes. The purchase of Western at a price in excess of the depreciated net original cost basis resulted in a utility plant acquisition adjustment of approximately $4.7 million. The other major impact on revenue requirements was the elimination of the deferred state and federal income taxes and unamortized investment tax credits of $12.8 million from the books of Western upon the transfer.

Plant Acquisition Adjustment

The plant acquisition adjustment is determined by calculating the difference in the depreciated net original cost and the purchase price of acquiring utility assets plus the acquisition costs. Western's response to Item 19 of the Commission's Order of April 24, 1990, item 19 reflected that the total acquisition cost used to determine the plant acquisition adjustment was $6 million. Western proposed to include the entire plant acquisition adjustment in the net investment rate base and to amortize the plant acquisition adjustment over 15 years.

In determining the reasonable cost of assets used to provide utility service, the Commission holds that the depreciated original cost is the appropriate standard. However, in a case involving Delta Natural Gas Company,[2] ("Delta") in 1987, the Commission allowed Delta to recover its plant acquisition adjustment. In that proceeding, the Commission established certain criteria which a utility must meet in order to justify the increased cost associated with the acquisition. The basic substance of the criteria which must be met is that the additional benefits of the acquisition in excess of book value exceeds the additional cost. These benefits related to both quality of service and economics.

In response to Item 4 of the Commission's Order dated May 30, 1990, Western addressed the criteria established by the Commission in the Delta case. Although many of the benefits are not quantifiable, Western argued that the ratepayers were realizing an immediate benefit resulting from the treatment of the gas inventory. This resulted in a rate base reduction of $3.8 million. Also, because of the deteriorating financial condition of the former owners, even though the gas distribution operations were not the cause of the financial distress, Western could have experienced increased capital costs had the transfer not taken place.

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2 Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc.

The AG argues that the plant acquisition adjustment should not be allowed because the primary reason for the acquisition adjustment is the $6 million in acquisition costs, which are excessive. The AG specifically takes issue with the $495,000 in bonuses paid to Atmos employees for their efforts in acquiring Western.

The Commission concurs with the AG's position that the acquisition costs are excessive to the extent that bonuses of $495,000 were paid to Atmos employees. While these may be valid costs incurred in connection with the acquisition, the stockholders of Atmos are the primary beneficiaries and Atmos should bear the cost of rewarding its employees for their efforts in the acquisition of Western. Therefore, the Commission has reduced the plant acquisition adjustment by $495,000 resulting in a reduction to amortization expense of $33,000 for rate-making purposes. The Commission is swayed by the uncontested arguments that cost savings will result from the change in ownership.

The Commission finds that the ratepayers and the stockholders of Atmos will both benefit from the acquisition of Western. Accordingly, the best method that will share these benefits and costs in the rate-making process is to allow the amortization of the adjusted plant acquisition adjustment in operating costs, but to exclude the acquisition adjustment from the rate base. This approach will give recognition to the additional investment to be borne by the ratepayers, but will require the stockholders to forego a return on the unamortized portion of the plant acquisition adjustment in return for the benefits they receive as a result of the acquisition.

Deferred Income Taxes

Although the purchase of Western by Atmos was technically a stock purchase, the method of recording the transfer resulted in the elimination of deferred income taxes in the amount of $12,783,597. The pre-acquisition deferred taxes were identified as Investment Tax Credits in the amount of $3,499,954 and Deferred Income Taxes of $9,283,643. In Western's rate cases prior to the transfer, rate base was reduced by the investment tax credits and the deferred taxes. The Commission has allowed full tax normalization for rate-making purposes for Western, and Western was realizing the benefits of these tax credits and deferrals prior to the transfer.

The transfer was treated as an asset purchase and the deferred taxes were eliminated by Western in the post-acquisition journal entries. Western argued throughout the proceedings that the tax attributes of the seller could not be retained by the buyer, since there was no continuing ownership interest retained by the buyer. The seller was required to treat the asset sale as a gain (or loss) for tax purposes and was liable for any taxes due, as a result of a gain, as well as any recapture of investment tax credits. Western contends that since the purchase was treated as an asset purchase, there was no way for it to retain the deferred taxes on its books. Western did not submit substantial evidence that its decision to purchase the assets rather than the stock was in the best interests of the ratepayers financially. At the hearing, Mr. Purser, Chief Financial Officer and Executive Vice President of Atmos, testified that Atmos had not done any studies comparing the financial impact on the ratepayers of acquiring the stock versus acquiring the assets of Western.

The Commission does not take issue with Western's interpretation of the IRS code requirements that the transfer, since it was in the form of an asset purchase, results in the elimination of deferred taxes. However, the election to treat the acquisition as an asset purchase, was by Atmos' choice and Atmos received various benefits by acquiring the assets, in return for the elimination of deferred taxes, such as the increase in the depreciable tax basis of the assets. The record does not indicate that the impact on ratepayers was a consideration in determining the method of acquisition.

The loss of deferred taxes and ITCs is of considerable interest to the Commission and an issue which has a significant impact on the revenue requirements in this case. In evaluating the revenue requirements effect of the elimination of these deferred taxes, consideration must be given to the sources of the deferred taxes as well as the method in which benefits are realized by the ratepayers. A knowledge of the tax deferral process is essential to a complete understanding of the issue. It should be understood that deferred taxes are considered cost-free capital to utilities. Deferred taxes are generated when income tax expense determined for book purposes exceeds income tax expense determined for tax purposes. This cost free capital is provided by the ratepayers of the utility through the tax normalization rate-making approach.

There are tax differences which are permanent and those which are the result of temporary timing differences caused primarily by differences in depreciation expense deductions for book and tax purposes. The temporary book/tax depreciation timing differences reverse in the later years of the life of the depreciable asset. Thus, the deferred taxes arising from temporary timing differences constitute a "loan" to the utility from the ratepayers, which is repaid when the book/tax timing differences reverse and the IRS tax expense is greater than the book tax expense.

There are actually three categories of deferred taxes which were eliminated in the transfer of Western. Of the $12,783,597, $3,499,954 are identified as unamortized investment tax credits. Investment tax credits are direct reductions in income tax expense at the time an investment is made in qualifying utility assets. The ratepayers incur tax expense initially as though these credits had not occurred and the excess tax payments are returned to the ratepayers over the useful life of the assets giving rise to the ITCs. These ITCs were considered a permanent tax reduction until the time of the transfer. At that point, a portion of the ITC was potentially subject to recapture, due to the sale of the assets.

The remainder of the deferred taxes consisted of deferred federal and state income taxes which would have been eliminated at the 34 percent tax rate when the book/tax depreciation timing differences reversed; and the excess deferred taxes which were created in 1978 when the maximum corporate income tax rate was lowered from 48 to 46 percent and in 1987 when the Tax Reform Act of 1986 ("TRA") lowered the maximum corporate income tax rate from

46 to 34 percent. The elimination of the deferred taxes required to offset tax expenses when the book/tax timing differences reverse were a temporary loss to the ratepayers upon the transfer of Western, whereas the elimination of the excess deferred taxes result in a permanent loss to the ratepayers.

Temporary Losses. The Commission concurs with Western's contention that the deferred taxes previously created by book/tax depreciation timing differences will be restored through greater deferrals subsequent to the transfer. The purchase of Western by Atmos and the increase in the depreciable tax basis eliminated the book and tax depreciable basis difference which had given rise to the deferred taxes on the books prior to the transfer. The depreciable tax basis now exceeds the net depreciable book basis which will further accelerate the restoration of the deferred taxes. By adjusting rate base to reflect the temporary loss of deferred taxes, which had previously been provided by the ratepayers, the Commission is restoring the investment which is due to the ratepayers and will be provided on the books of Western over the next few years. The Commission believes that the ratepayers should not be required to wait until these deferred taxes are restored to realize the benefits for the dollars they contributed prior to the transfer. By restoring these deferred taxes through a rate base reduction now, Western will not realize the double benefit of having an increased rate base for rate-making purposes as well as a decreasing rate base and higher annual earnings through the process of restoring the deferred taxes in future years. The book effect of the rate base reduction will only be realized by Western during the period of time that the deferred taxes are not restored.

Permanent Losses. The elimination of the unamortized investment tax credits upon the transfer of Western resulted in a permanent loss to the ratepayers of funds provided for taxes. Western stated that the ITCs were subject to recapture and the seller was responsible for payment of the previously utilized tax credits. The Commission does not dispute Western's position that a portion of these ITCs would have become a tax liability of the seller upon the transfer. The fact remains, however, that the ratepayers provided the funds to cover the cost of these taxes in advance, and the action of the seller created the tax liability which would not have occurred had the transfer not occurred. There is no information in the record in this case which would allow the Commission to readily identify what component of the ITC was subject to recapture. Even if these amounts could be identified, the ITCs would not have been recaptured if the sale had not occurred. The payment of these additional taxes should be arranged in the purchase/sale transaction between the buyer and seller and the increased cost, if any, should not be borne by the ratepayers.

The excess deferred taxes resulting from the TRA tax rate reduction and the 1978 tax rate reduction, from 48 to 46 percent, should be restored to the benefit of the ratepayers. The TRA provided that the excess deferred taxes resulting from the tax rate reduction should be returned to the ratepayers using the average rate assumption method. This method would have flowed this tax benefit back to the ratepayers of Western over the remaining useful life of the assets. Upon the sale of Western, the seller was not required to remit any of these excess deferred taxes to IRS since the tax rate should not have exceeded 34 percent. Once again, the seller was responsible for taxes on its recorded gain on the sale of the assets. As with the other permanent losses, the funds were provided by the ratepayers and should not result in an increase in rate base for the ratepayer. The ratepayers did not share in the gain realized by the seller; therefore, they should not be responsible for the taxes.

Western's primary rebuttal to questions at the hearing and to the testimony of the AG regarding the elimination of ITCs and deferred taxes, was that the ratepayers would benefit from the increase in the depreciable tax basis of the assets and the deferred taxes would be restored through MACRS depreciation. This observation is true with regard to the deferred taxes which were lost temporarily; however, the investment tax credits and the excess deferred taxes will not be restored and will result in a permanent loss to the ratepayers. The Commission finds that the ratepayers should not bear the loss of these deferred taxes. Therefore, an adjustment should be made, for rate-making purposes, to restore the liability and refund these losses to the ratepayers. For rate-making purposes, the temporary losses and permanent losses are treated differently. The temporary losses should be deducted from rate base with no amortization, since these deferred taxes will be restored. The permanent losses should be deducted from rate base and amortized over the remaining book life of the assets at the time of the transfer. This will, in effect, provide the same rate-making impact that would have occurred without the transfer.

The Commission's decision on the loss of investment tax credits and deferred taxes results in a reduction to rate base of $12,783,597 and a reduction to income tax expense of $233,330 for amortization of the investment tax credits and a reduction to income tax expense of $131,081 for amortization of the excess deferred taxes. The amount of excess deferred taxes was estimated by applying 26 percent to the level of deferred taxes on the books at the time of the transfer. The 26 percent factor represents the change in the maximum corporate income tax rate from 46 to 34 percent.

Valuation of Working Gas

Western proposed to increase its rate base by $2,801,235 in order to revalue its working gas storage to reflect the Texas Gas Zone 3 price as established in Western's Gas Cost Adjustment Case No. 9556-M[3] ("GCA 9556-M").[4]

The AG proposed a reduction of $1,818,257 in the working gas storage balance based on the premise that a portion of the gas remained in storage throughout the test period.[5] Since the entire

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3 Case No. 9556-M, Notice of Purchased Gas Adjustment Filing of Western Kentucky Gas.

4 Exhibit MSL-8, page 4.

5 DeWard Prefiled Testimony, page 21.

amount of working gas was not withdrawn from storage, the value of the gas stored will never equal the current price used by the company to price out the gas. The AG therefore argues that Western should value working gas inventory by excluding the amount at the point of the lowest storage level, that being at April 30, 1989. The AG's proposal would reduce the rate base by $1,818,257.[6]

KLS proposed that Western's adjustment to its working gas storage should be eliminated completely because it does not reflect a known and measurable change.[7] In support of its position, KLS states: 1) the adjustment is based upon an estimate; 2) the estimate varies over time; 3) the gas purchased will not necessarily be the gas stored; and 4) the adjustment will lock into rates an estimated gas cost despite the certainty that this cost will fluctuate.[8]

According to Western's response to an interrogatory during discovery and during cross-examination, Western's witness stated that its underground storage is priced at average cost. Western's witness further states that Western is asking for a return on inventory that is valued at the higher of the average cost and

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6 Exhibit TCD-1, Schedule 6.

7 Brief of KLS, page 5.

8 Id., page 4.

the Texas Gas Zone 3 price.[9] The Commission believes it to be inappropriate for Western to revalue its inventory for rate-making purposes at a value higher than its cost; and although the KLS proposal has merit, the Commission believes that an average rather than the test-period-end valuation is the more appropriate method because an average will account for any abnormalities that may occur during the test period. The Commission finds that the AG's proposal for revaluation is the more appropriate method.

Cash-Working Capital Allowance

Western proposed, as a component of its rate base, a cash-working capital allowance of $2,864,951.[10] Western derived this amount based on the 1/8 formula method.

The AG has proposed a complete elimination of this adjustment because the formula method "always produces a working capital allowance, but does not produce an amount which truly represents a working capital requirement."[11] The AG further states that Western has not justified its need for a cash-working capital requirement.

The Commission is aware of the AG's position regarding the 1/8 formula method for determining a cash-working capital allowance; however, the Commission is not persuaded to abandon the formula method in this case and will allow Western to calculate

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9 T.E., Vol. IV, page 25.

10 Exhibit 6, page 4.

11 DeWard Prefiled Testimony, page 23.

its cash-working capital requirement in this manner. The Commission, however, will reduce Western's proposed cash-working capital requirement by $150,272 to reflect the level of operation and maintenance expenses found reasonable in this case.

Computer Equipment

Included in Western's plant in service component of its rate base is computer equipment in the amount of $2,158,659 that was sold subsequent to the test period. Also included was associated accumulated depreciation in the amount of $1,181,331. The record in this proceeding indicates that the computer equipment was located at Western's office in Owensboro and was sold in February 1990.[12]

The AG contends that since the computer has been sold, Western should not be allowed a return on the equipment and should not be allowed to recover the associated depreciation expense.[13]

Western stated that although the equipment had been sold and was no longer in service, it was the only computer system on which the company was seeking a return and a recovery of costs.[14] Western's witness testified that no costs from the corporate data processing functions nor any actual test-period costs that had been removed during the test period are included in this proceeding.[15]

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12 Brief of Western, page 35.

13 DeWard Prefiled Testimony, page 14.

14 Brief of Western, page 36.

15 T.E., Vol. III, page 213-214.

The Commission is very concerned about allowing any utility to earn a return on plant that is not only no longer in service, but is no longer owned by the utility. On the other hand, the Commission would be hesitant to not allow a utility to recover a properly incurred cost of operations. Western has stated in its brief that at the time of its filing of this case, neither the timing of the sale nor the proper amount to be allocated by the corporate office was known.[16] If the Commission disallowed Western recovery of the computer that was sold, it would be, in effect, barring Western from recovering most of its data processing costs. The Commission believes that Western should be allowed the return on the equipment that was sold and finds that Western has included an appropriate amount in its rate base for computer equipment.

12-Month Average for Underground Storage

The AG proposed a $275,436 reduction to Western's rate base using a 12-month average to value Western's gas stored underground as opposed to the usual 13-month. The AG's rationale for this proposal is that the inclusion of 13 months artificially inflates the balance by using two of the three highest month balances of the period.[17]

This Commission has generally used the 13-month average for gas inventory and other rate base components as well as revenue and expense items. The basis for use of the 13-month average is

[16] Brief of Western, page 35.

[17] DeWard Prefiled Testimony, page 22.

to dilute any abnormalities that may occur during the test period and to include the average for the appropriate time span. The Commission is not persuaded to abandon the 13-month average in this case.

Construction Work in Progress ("CWIP")

The AG proposed that Western's rate base be reduced by $107,341 to remove CWIP for which Western is expected to be reimbursed.[18] The Commission agrees.

Western contends that it is not known if the company will actually receive reimbursement for these items, but stated that it was subject to reimbursement of these items.[19]

Rate Base Determination

Based upon the above discussion, the Commission has determined Western's net investment rate base at September 30, 1989 to be $63,401,818, determined as follows:

Gas Plant in Service	$119,822,147
Construction Work in Progress	693,488
Gas Stored Underground	1,775,865
	$122,291,500
Deduct:	
Accumulated Depreciation	(57,995,843)
Transfer Related Deferred Tax Losses	(12,783,597)
Retirement Work in Progress	(189,566)
Customer Advances for Construction	(3,398,193)

18 DeWard Prefiled Testimony, page 23.

19 Response to AG Data Request, March 30, 1990, Item 9.

Add:	
Cash-Working Capital Allowance	2,714,679
Prepayments	699,813
Materials and Supplies	997,337
LP Gas Inventory	68,482
Working Gas Storage	10,997,206
Total Net Investment Rate Base	$ 63,401,818

CAPITAL STRUCTURE

Western proposed a capital structure of 50.58 percent debt and 49.42 percent common equity based on the actual end-of-test-year capital structure of Atmos, divided between long-term debt and equity. Western did not include in its capital structure short-term debt of $31,600,000 which was outstanding at the end of the test period, stating that "the capital structure of Atmos is reasonable excluding short-term debt" and "short-term debt is not permanent and regularly has to be retired and replaced."[20]

The AG proposed a capital structure of 50.00 percent long-term debt, 8.50 percent short-term debt, and 41.5 percent common equity. The AG proposed to include the average daily balance of short term debt for the test year of $15,880,500 in the capital structure, and also proposed to include $14,000,000 of additional long-term debt because this commitment was made prior to the end of the test year and an initial placement was made within 11 days of the test year.

The Commission finds that the adjusted capital structure as recommended by the AG is reasonable with one exception. The AG's proposed amount of short-term debt of $15,880,500 differs slightly

[20] Response to Commission's Order dated April 24, 1990, Item 35.

from the average daily amount of $15,858,356 provided by Western; the Commission accepts the amount provided by Western as correct. The capital structure should reflect short-term debt because Western uses significant amounts of short-term debt on an ongoing basis and the additional $14,000,000 long-term debt issuance should be reflected in the capital structure because it is known and measurable and occurred shortly after the end of the test period. Therefore, for rate-making purposes the capital structure for Western should be as follows:

	Amount	Percent
Long-Term Debt	$ 93,552,812	49.99
Short-Term Debt	15,858,356	8.47
Common Equity	77,730,000	41.54
	$187,141,168	100.00

REVENUES AND EXPENSES

Western reported test-period operating income of $10,369,695.[21] In order to normalize current operating conditions, Western proposed several adjustments to revenues and expenses which resulted in adjusted operating income of $4,710,874.[22]

Revenue Normalization

Western proposed normalized gas operating revenues of $112,477,915 based on the rates in effect at the time the application was filed. This amount consisted of $78,077,942 in gas cost revenues and $34,399,973 in base rate revenues. Though not an issue in this case, the total amount of gas cost revenues

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21 Exhibit 5, page 1.
22 Exhibit 6, page 3.

is a major component of Western's revenues and its rates. The rates authorized in this case will include gas cost recovery of $67,027,082, reflecting Western's latest gas cost adjustment effective August 1, 1990.[23] Purchased gas cost has been adjusted in a similar manner to reflect Western's current cost of gas.

In normalizing its revenues, Western increased its sales and transportation volumes by 423,890 Mcf and 12,321 Mcf, respectively, to reflect its adjustment for weather normalization. Western decreased its sales volumes by 39,500 Mcf and increased transportation volumes by 165,100 Mcf to reflect normalized deliveries to large volume industrial customers. The Commission finds Western's adjustments to be reasonable and accepts Western's normalized base rate revenues.

<u>Merchandise Sales and Jobbing</u>

The AG proposed that Western's net income be increased by $322,784 by moving net income associated with merchandising and jobbing above the line.[24] The AG contends that there has not been a proper allocation of the expenses below the line and it is, therefore, inappropriate to include the income below the line. Western maintains that it has properly recorded both the revenues and expenses, per the Uniform System of Accounts ("USoA"), for the

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23 Case No. 9556-O, Gas Cost Adjustment Filing of Western Kentucky Gas Company, Order dated August 1, 1990.

24 DeWard Prefiled Testimony, page 24.

merchandising and jobbing and that the AG had ample opportunity to examine the books and ledgers and to determine if Western had correctly recorded revenues and expenses.[25]

Upon thorough analysis, the Commission believes that Western has not properly segregated the expenses associated with merchandise sales and finds Western's test-period revenues should be increased by $322,784, resulting in an increase to net operating income of $195,462.[26] The expenses are discussed in more detail in another part of this Order.

Amortization Expense

Based upon treatment of the acquisition adjustment as discussed in a previous section of this Order, the Commission finds that Western's proposed amortization expense should be reduced by $33,000, resulting in an increase to net operating income in the amount of $19,983.

Employee Dinners and Awards

Western proposed to include in test-period expenses an amount of $109,086 for employee service awards and dinners.[27] Included in this amount is approximately $55,000 for Rolex brand watches given to 16 employees with at least 30 years of service.[28]

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25 Lovell Rebuttal Testimony, page 35.

26 $322,784 x .60555 (tax factor) = $195,462.

27 Brief of Western, page 70.

28 Lovell Rebuttal Testimony, page 15.

The AG proposed to disallow the entire amount as excessive and inappropriate expenditures that should not be borne by the ratepayers.

This Commission has in the past allowed reasonable levels of expenditures for employee service awards. However, the Commission believes that in this case Western's expenditures are excessive. The Commission does not object to Western or any utility rewarding its employees for their service, but believes utilities should use discretion in their expenditures. The Commission does not believe that the ratepayers of Western should be forced to provide premium watches for Western employees. The Commission finds that such an expense should be borne by Western's shareholders and therefore reduces Western's test-period expenses by $55,000, the cost of the premium watches. The Commission will allow the remainder of the service awards and dinners. This results in an increase of $33,305 to Western's net operating income.

Aircraft Charges

Western included $185,899 in aircraft expenses allocated to Western. The AG proposed to eliminate the charges since Western no longer leases aircraft and the charge will be nonrecurring.

Western has stated that although the company no longer leases aircraft, the expense has been replaced by commercial airfare.

The Commission notes that there were significant charges in the test period for commercial and charter aircraft and the allocated charges to Western were in addition to charges that were directly charged to Western. The Commission finds that the test period contained adequate charges for aircraft and due to the non-recurring nature of the allocated charges, Western's test-period expenses should be reduced by $185,899, the total allocated aircraft charges. This increases Western's net operating income by $112,571.

Country Club Charges

A total of $68,333 of expenditures in the test period were identified by various parties as country club dues or country club related charges.[29]

This Commission has in the past found that such charges should be borne by shareholders and not the ratepayers. The Commission so finds in this case and will reduce Western's operating expenses by $68,333, resulting in an increase to net operating income of $41,379.

Outside Services

The AG contends that Western's operating expenses should be reduced by $132,133 to eliminate expenses paid for temporary clerical services, principally provided by Kelly Services. The AG claims that these expenses are not necessary and are non-recurring.[30] The AG further states that the expenses are duplicative because the expenses are recorded elsewhere. The AG also claims that Western's annualized payroll includes amounts for

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29 Exhibit TCD-1, Schedules 40, 41, and 42.

30 DeWard Prefiled Testimony, page 39.

employee salaries when actually some employees leave and are not immediately replaced.[31]

Western argues that the expenses are necessary and that they are an ongoing business expense.[32]

The Commission believes that there is some duplication of expenses because Western has been provided reasonable levels of wage expense and overtime and has failed to show that the temporary services provided do not duplicate work provided by Western's regular staff. The Commission, therefore, finds that Western's expenses should be reduced by $132,133, resulting in an increase to net operating income of $80,013.

Consultant Fees

The AG proposed that the consulting fees paid to C. R. Hayes, the retired president of Western, for the test period be disallowed. The AG's argument was that Mr. Hayes now resides outside of Western's operating area and over time the value of his services to Western will diminish.

Western contends that its decision to retain Mr. Hayes as a consultant was wise and prudent because of his extensive knowledge of the Western system.

This Commission has no doubt that Mr. Hayes provided Western a very valuable service and that his extensive knowledge and experience regarding Western's operations proved very valuable to

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31 Id.

32 Brief of Western Kentucky Gas, page 63.

Atmos in the time immediately subsequent to the acquisition. However, the Commission feels that over time Mr. Hayes' services to Atmos will not be necessary and that to continue to allow recovery through rates of compensation to Mr. Hayes would be inappropriate. The Commission therefore reduces Western's operating expenses by $33,487 for consulting fees paid to Mr. Hayes and country club charges incurred on his behalf. This action increases Western's net operating income by $20,278.

Audit Accruals

The AG proposed a reduction of $48,000 to Western's operating expense. The amount is the result of Western being assigned audit expense from the corporate level because Western maintained a separate ledger. Beginning January 1, 1990, Western no longer maintains a separate ledger and the AG argues that the charge will be nonrecurring and should be removed from test-period operations.[33]

Western states that although its ledger is now combined with the other operating divisions and the cost will in the future be allocated to Western, the costs of audits, in this case, are not included in its proposed allocations from the general office. Since this cost will continue on an annual basis, as an

33 DeWard Prefiled Testimony, page 35.

allocation, an amount for this expense should remain in the test period.[34]

Since Western did not make a provision to include the amount in its general office allocations, the Commission finds that it is reasonable to allow the charge in test-period operatiohs.

Intracompany Payroll Charges

A reduction to Western's test-period operating expense was proposed by the AG for charges by Atmos to Western for the services of two Atmos employees included on Western's payroll. Western has stated that it agrees with the AG's proposal.[35]

The Commission finds the expenses unreasonable. Western's operating expenses should be reduced by $134,194 to reflect the removal of these charges. This results in an increase of $81,261 to Western's net operating income.

Payroll

Western proposed to increase from 83 percent to 88.6 percent the level of wages expensed, thus reducing the level of wages capitalized. The proposal is based on an accounting change that allows capitalization of administrative and general expense ("A&G") at the corporate level and discontinues capitalization of such charges at the division level.[36]

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34 Brief of Western, page 59.

35 Brief of Western, page 60.

36 Lovell Prefiled Testimony, page 18.

The AG proposed that Western be allowed to increase its percentage of capitalized wages from 83 percent to 83.54 percent. The AG also proposed that Western's annualized wage levels be adjusted to reflect work force reductions that occurred in February 1990.[37]

Western has accepted the AG's proposal to adjust the annualized wage levels due to subsequent work force reductions.[38] However, Western takes issue with the AG proposal to decrease Western's percentage of wages to be expensed. Western states that A&G functions have moved away from the division level and these duties are now more appropriately performed at the corporate level. Since the functions are being performed at the corporate level, the costs should be capitalized at that level.

The Commission agrees that if the costs are being incurred at the corporate level, they should be capitalized at that level and the appropriate allocation made to the division. The problem that the Commission finds is that if services are transferred from the division level to the corporate level, and costs should follow, then it would stand to reason that costs at the division level should decrease. According to Western, the A&G expenses at the division level were merely reclassified from A&G expenses to distribution costs.[39] Western did not indicate that costs at the division level would decrease, but that the amount allocated to

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37 DeWard Prefiled Testimony, page 37.

38 Brief of Western, page 61.

39 T.E., Vol. IV, page 30.

Western from Atmos would decrease.[40] The Commission, for these reasons, rejects Western's proposal and will reduce operating expenses by $682,853, the amount proposed by the AG. This will increase Western's net operating income by $413,502.

Payroll Taxes

Based on the above adjustment to payroll, the Commission finds that Western's payroll taxes should be reduced by $51,282, the amount proposed by the AG, thus increasing net operating income by $31,054.

Demonstration and Selling Expense

The AG proposed to reduce Western's demonstration selling expense, Account 912, by $664,895. This amount includes the entire test-period amount in Account 912 with the exception of an allowance for the salaries of two marketing representatives.[41] The costs included in Account 912 are broken down as follows: (1) builders' trip to San Francisco, $47,146; (2) Affordable Gas Home Program, $169,391; (3) Customer on the Main Program, $160,055; and (4) Labor costs of $250,965.[42] In addition, there were other costs identified as gift certificates and incentives to encourage the use of gas appliances. The AG's arguments revolves around 807 KAR 5:016, Section 4. This regulation deals with the subject of

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40 Id.

41 DeWard Prefiled Testimony, page 45.

42 AG Data Request, March 30, 1990, Item 77.

disallowed advertising. The AG contends that the charges in Account 912 constitute disallowed advertising under 807 KAR 5:016 (4).

Western states in its brief that the expenses incurred and recorded in Account 912 do not constitute promotional advertising as defined in KAR 5:016.[43] Western contends that 807 KAR 5:016, Section 4(1)(d), allows the type of activity that gave rise to the expenditures recorded in Account 912, and that portion of the regulation defines what is not promotional advertising.

The USoA does not classify Account 912 expenditures as advertising. The Commission does believe that some of the expenses in Account 912 should be disallowed on the basis that they constitute promotional advertising. In addition, the USoA excludes any demonstration and selling expenditures from Account 912 that were incurred as a result of merchandising activity by the utility. Western has failed to show that it segregated the labor costs and other expenses associated with merchandising and jobbing from appropriate above the line expenses. For the above reasons, the Commission will not allow any of the Account 912 expenses for rate-making purposes. In any case, this Commission would have disallowed the cost of the San Francisco builders' conference. This cost should not be borne by the ratepayers. The reduction of expenses by $721,223 increases net operating income by $436,737.

[43] Brief of Western, page 77.

Heat Pump Advertising

The AG proposed a reduction of $86,881 to Western's operating expenses for the removal of costs related to heat pump advertising.

The expenses incurred for heat pump advertising are clearly prohibited by regulation. 807 KAR 5:016, Section 4(1)(b), reads:

> Promotional advertising means any advertising for the purpose of encouraging any person to select or use the service or additional service of an energy utility, or the selection or installation of any appliance or equipment designed to use such utility's service. (emphasis added)

Advertising designed to persuade consumers to switch from electric heat pumps to gas furnaces constitutes promotional advertising, and expenses incurred for such advertising are prohibited for rate-making purposes. The Commission, therefore, reduces Western's operating expenses by $86,881, thereby increasing net operating income by $52,611.

Miscellaneous Sales Expense

Western included in its Miscellaneous Sales Expense $35,735 for a trip to Las Vegas for employees who achieved certain sales levels for gas grills and yard lights.

Also included is $1,900 for twenty season tickets to basketball games for Kentucky Weslyan College.

The AG has proposed removal of the above expenses.

The costs of the Las Vegas trip should be disallowed. Any benefit that the ratepayers may have derived from this conference could have been accomplished by less expensive means. In addition, the Commission believes that the cost of this campaign constitutes promotional advertising and should be disallowed. The Commission, therefore, finds that the costs should not be borne by Western's ratepayers and has reduced Western's operating expenses by $35,735. Further, the Commission finds that Western's operating expenses should be reduced by an additional $1,900 spent for Kentucky Weslyan basketball tickets. The Commission finds ratepayers should not bear the costs of attendance to athletic events by utility employees.

The result of the above adjustments increases Western's net operating income by $22,790.

LP Gas Expense

The AG proposed removal of $4,836 of costs associated with Western's liquefied petroleum gas ("LP Gas") expense. It is the AG's contention that such costs are recovered through Western's quarterly gas cost adjustment.

Western contends that the AG is wrong and that the expense is not recovered through the gas cost adjustment.

The Commission finds that Western does recover such costs through the CGA and will allow the AG's proposed adjustment. This will increase net operating income by $2,928.

Direct Payments to Western Employees

The AG proposed a reduction to Western's operating expenses to remove expenditures that were made directly to Western employees. The AG provided no support for this proposal other than to state it allowed full annualization of wages.[44]

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[44] DeWard Prefiled Testimony, page 40

Western has stated that the payments were to reimburse employees for expenses they incurred while performing their job duties and are not a part of the employees' compensation.[45]

The Commission finds the expenditures were appropriate.

Group Insurance

The AG proposes to reduce Western's test-period expenses by $269,787 to reflect an adjustment to group insurance expense. The AG reached this conclusion by annualizing one month of billings and adding that number to the actual claims paid for the test period.[46]

Western's witness established that the difference in the company proposal and the actual test-year expenditures was approximately $8,000.[47]

It is not reasonable to base a proposal on one month annualized. Western has provided a much more appropriate number based upon the test-period actual.

Supplemental Retirement Benefits

The AG proposed a reduction of $64,166 in retirement benefits given to what the AG refers to as "certain key employees."[48] The AG offered no other support for the proposal and as such the Commission finds it to be without merit. The supplemental

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[45] Lovell Rebuttal Testimony, page 36.

[46] Exhibit TCD-1, Schedule 23.

[47] Exhibit MSL-16.

[48] DeWard Prefiled Testimony, page 42.

retirement benefits are reasonable and an allowable rate-making expense.

Personal Use of Company Automobiles

The AG objected to Western's inclusion in rates its expense in furnishing automobiles to some of its employees while allowing personal use of these autos. The AG simply states that the costs should not be borne by the ratepayers, but offers no insight as to why.[49]

The Commission has in the past allowed such costs as reasonable and is not persuaded to change in this proceeding.

Benefits

Western proposed to increase its benefits expense by $177,703.[50] The adjustment was proposed to correspondingly increase benefits to match the increased payroll.

The AG objected to this proposal because Western provided no documentation to support the total benefits package. Western based its proposed increase upon an approximate 21 percent benefits to payroll relationship, calculated based upon historical data. The Commission finds that both Western's benefits level and the methodology employed to determine the increase to be reasonable.

Liability Insurance

The AG proposed to reduce Western's operating expenses by $263,300 to exclude the test-period costs of excess Property Loss

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49 DeWard Prefiled Testimony, page 43.

50 Exhibit 5, page 16.

and Property Damage insurance. The AG contends that Western provided no support for the expense.[51]

The Commission finds that Western has adequately supported its position by the production of actual insurance policies that state the cost to Western. The AG has not provided adequate information and has not offered evidence of a more appropriate level of cost.

Arthur Andersen Fees

Western retained the services of the accounting firm of Arthur Andersen to assist it with the management audit. The AG proposed that the fees, in the amount of $50,970, be disallowed and states that he has proposed allowance of the full cost of the management audit to be amortized over a 3-year period.[52]

The Commission finds that Western was not unreasonable in retaining the benefit of experts to assist it with the management audit. The Commission does not feel that the fee is excessive and that Arthur Andersen provided a reasonably necessary service.

Based upon the above, the Commission finds that the fee should be allowed for rate-making purposes. The Commission will, however, require amortization of the cost over a three-year period. This action results in a decrease of $33,980 to operating expense and an increase to net operating income of $20,577.

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51 DeWard Prefiled Testimony, page 44.

52 Id., page 49.

Attorney Fees

The AG proposed that $40,730 of legal fees incurred by Western be removed from test-period expenses because the fees represent a duplication of services.[53] Western merely changed law firms for representation of FERC matters during the test period.

The Commission finds that Western's legal fees for the test period are appropriate and should be allowed for rate-making purposes.

American Gas Association ("AGA") Dues

The AG proposed that $35,384 of expenses that represent AGA dues be removed from this rate proceeding. The AG contends that the fees are excessive based on the 1989 allocated amount and that a portion of the fees represent advertising and lobbying activities that would be disallowed for rate-making in Kentucky.[54]

Western argues that the AG inappropriately went beyond the test period by including the total amount of 1989 expenditures for comparison purposes.

This Commission has always supported membership in the AGA and the USoA allows for inclusion of AGA dues above the line. The Commission, however, does not believe that the AG's adjustment is inappropriate. The amount that the AG proposed to exclude for lobbying and advertising is reasonable. Also, Western has failed to adequately explain the difference between the allocated amount

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53 DeWard Prefiled Testimony, page 49.

54 DeWard Prefiled Testimony, page 50.

of AGA dues and the actual expenditure. The Commission reduces Western's test-period expenses by $35,384, resulting in an increase to net operating income of $21,427.

Workers' Compensation Audit

The AG proposed disallowance of a $14,000 payment for a Workers' Compensation audit by stating that it was for a prior year's audit. The audit covered the prior year's activity but the actual audit took place during the test period and the cost was incurred during the test period. The Commission therefore finds the payment to be appropriate.

Clearing Account Balances

The AG proposed a reduction to operating expense in the amount of $107,255 attributable to excessive levels of expenses in clearing account balances. The AG states that the expenses were incurred in a prior period but were deferred to a clearing account.[55]

The majority of the clearing account balances that the AG proposes to disallow includes account 163 undistributed stores expense. It would appear that Western has properly accounted for the expenses in the clearing accounts. Western argues and the Commission agrees that the AG's proposed adjustment violates the USoA, accrual accounting principles, and creates a mismatch.

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55 DeWard Prefiled Testimony, page 51

Relocation Expense

The AG proposed removal of $22,687 from the test period. This amount represents the loss on the sale of homes of employees that were relocated by the company.

Western argues in its brief that a proposal such as the one the AG has made would result in less than desirable circumstances because the employees would not be able to move or Western would be required to compensate the employees at a higher rate.

The Commission does not believe that the ratepayers of Western should have to bear the loss on the sale of Western employees' homes. Excluding this loss from test-period operations will increase net operating income by $13,738.

Account 921

The AG cites several charges that it claims are inappropriate for rate-making and has proposed removal of the expenses. The charges are located in Account 921, Office Supplies and Expenses, and total $11,863.[56]

After analysis of the charges, the Commission finds that some of the charges are inappropriate and they should be disallowed for rate-making purposes. Such charges include charges for golf outings, Kentucky Derby, and other expenses listed on TCD-1, Schedule 44, except the expenses for the stock promotion meetings and the management retreat. The total of the disallowed expenses is $6,129. This will increase net operating income by $3,711.

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56 Exhibit TCD-1, Schedule 44.

Corporate Allocations

Western proposed a methodology for allocation of costs from the corporate to the division level. As a result of its proposal, Western would increase its operating expenses by $3,193,002 in order to reflect the current level of allocations.[57]

Prior to this proceeding, Atmos allocated corporate services to Western based upon the methodology used by Western's prior parent TAE. TAE allocated charges to Western in the amount of $332,400 annually. Subsequent to the acquisition of Western by Atmos, the allocation method used by TAE was continued as a temporary measure until Atmos could analyze and develop a more appropriate method.

The recent management audit of Western included specific recommendations concerning cost allocations. Recommendations IV-R1 provide for the development of an activity-based cost allocation system, documentation in a procedures manual, and review by the Commission prior to implementation. With minor exceptions, Western approved both recommendations and developed implementation plans.

Western's proposal calls for costs to be assigned to operating units on a direct basis whenever practical and when responsibility for the cost can be determined. Western has proposed that a business need for resources can be determined based on: (1) levels of investment, (2) business activity levels,

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57 Exhibit 5, page 3.

and (3) human resource requirements.[58] The factors derived by Western to determine business activity levels include: (1) Assets or direct plant; (2) Mcf received into the system; (3) number of customers; and (4) the number of employees. It was then determined, based upon the above activity factors, that Western represents roughly one-third (32.53 percent) of the total Atmos assets and operating activity.[59] Based upon these factors, Atmos determined the amount of costs from each corporate department that should be allocated to the division level.[60]

The AG identified what it stated to be problems with the proposed allocation methodology. First of all, the AG stated that this Commission should undertake an audit at the Atmos corporate level basically for verification of all expenditures to determine appropriate allocation treatment.[61] The Commission does not agree that this is necessary at this time.

Some of the specific problems that the AG has with Western's proposed allocation methodology are shown on Exhibit TCD-1, Schedule 13-3. The AG believes that there are duplicate positions at each level, such as a Western president and an Atmos corporate president.[62] The AG also contends that costs that were formerly

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58 Lovell Prefiled Testimony, page 11.

59 Id., page 12.

60 Exhibit MSL-1.

61 DeWard Prefiled Testimony, pages 8-9.

62 Id., page 28.

directly assigned to specific operating divisions are now being allocated to all divisions.[63]

In the Management Audit Action Plan Progress Report, Western indicated that implementation of the actual plan was still in progress. For the purposes of this proceeding, the Commission has accepted Western's $3,193,002 pro forma adjustments to increase operating expenses for corporate allocations; however, the Commission does not accept Western's proposed allocation methodology. Western should continue to implement the cost allocation recommendations of the management audit. It is apparent from the record that Western does not have all of the allocation procedures in place. For example, Western did not include data processing costs or audit costs in its proposed overhead allocations. Until Western has implemented all of the recommendations in the management audit that apply to the cost allocation, the Commission will not give its approval to Western's proposed methodology.

The Commission has reduced Western's operating expenses by $3,650 to reflect a subsequent revision made by Western to its initial filing thus reducing allocations. This will increase net operating income by $2,210.

Rate Case Expense

In its filing, Western proposed a level of rate case expense of $93,000. In response to requests at the hearing, Western filed

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63 Id., page 28.

an updated amount of $216,309.[64] Western has proposed amortization of these costs over a two-year period.

The Commission expresses its concern with the level of costs incurred in this proceeding, but will allow the total amount. The Commission finds, however, that the costs should be amortized over a three-year period instead of two. This action increases Western's proposed operating expenses by $25,603 which decreases Western's net operating income by $15,504.

Pension Expense

The AG proposed a reduction to Western's test-period operating expenses in the amount of $467,605.[65] The AG bases its proposal on actuarial studies that assume Western's pension plan would not bear any of the plan's administrative costs. The AG also contends the expense should be reduced because the plan is overfunded.

Western argues that the pension costs included in this proceeding are appropriate because they are the actual costs incurred during the period. The costs include administrative costs, actual costs per FAS 87 and direct payments.[66]

The Commission notes that Western's pension fund is overfunded; however, the overfunding helps to lower the costs to the company and, therefore, the ratepayer. In addition, under

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64 Western Kentucky Gas, Summary of Rate Case Expenses, Filed August 2, 1990.

65 DeWard Prefiled Testimony, page 41.

66 Brief of Western, page 67.

current accounting, the plan will not remain overfunded. At some time Western will be required to begin to increase its contribution. There should be no reduction.

Interest Synchronization

Based upon the rate base, capital structure, and rate of return, found reasonable by this Commission in this proceeding, the Commission has calculated an interest deduction for income tax purposes of $3,806,334, a reduction to Western's proposed interest expense of $4,252,781.[67] This results in an increase to income tax expense and a decrease to net operating income of $176,101.

Federal and State Income Tax Expense

Western proposed total federal and state income tax expense of $3,770,238. Western calculated the pro forma expense based on a Kentucky state tax rate of 7.25 percent. Subsequent to the filing of this proceeding, the rate was changed to 8.25 percent and the Commission has accordingly increased Western's income tax expense by $4,939 resulting in a decrease to net operating income of the same.

The AG proposed several adjustments to Western's income tax expense. The AG proposed a $100,000 deduction for employee stock ownership plan dividends ("ESOP"), a $50,000 adjustment for savings realized from filing a consolidated tax return, and a $950,000 deduction for depreciation on the excess of tax basis of assets over book basis.

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67 Exhibit 5, page 1.

The AG's proposed deduction of ESOP dividends is based only on an estimated number and cannot be accepted.[68]

Regarding the AG's proposal to adjust for savings from a consolidated return, the Commission finds that since the tax expense is calculated on a going forward basis, any savings that may result is not known at this time.

Due to the treatment of the deferred tax items in the rate base section of this Order, the proposal to reduce taxes on the excess of tax basis over book basis is not necessary.

RATE OF RETURN

Cost of Debt

Western proposed a cost of long-term debt of 10.31 percent. Because Western proposed to exclude short-term debt from its capital structure, Western did not propose a cost of short-term debt. However, upon requests from the Commission, Western proposed that if short-term debt were to be included, it should be priced at the weighted average cost of capital excluding short-term debt.[69]

The AG proposed a cost of long-term debt of 10.31 percent and a cost of short term debt of 9.30 percent. The rate proposed by the AG was the average cost, calculated on a daily basis, at the end of December 1989.

The Commission finds that the cost of long-term debt should be 10.31 percent. The Commission further finds that, because short-term debt rates fluctuate continuously, the cost of short-

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68 DeWard Prefiled Testimony, page 55.

69 Id.

term debt should be the average short-term rate for the test period of 10.03 percent.[70]

Return on Equity

Western recommended a return on equity ("ROE") in the range of 14.50 to 15.00 percent.[71] Western's recommendation was based on a discounted cash flow ("DCF") analysis for 15 gas distribution utilities, as well as comparative DCF analyses of electric utilities and unregulated companies. Western concluded that the average cost of common equity for gas distribution utilities is at least 13.50 percent based on a dividend yield of 7.08 percent and a dividend growth rate of 6.35 percent, and argued that special risk factors of Atmos and Western increase the required ROE by 1.0 to 1.5 percent.

The AG recommended an ROE in the range of 12.00 to 12.50 percent, based on a DCF analysis of five gas distribution utilities. The AG used four methods for developing the growth estimate for the DCF analysis: compound growth in dividends per share, compound growth in earnings per share, compound growth in book value per share, and the earnings retention ratio multiplied by the ROE. Each of the methods yielded substantially different results, ranging from the 2.92 percent growth estimate using earnings retention ratio times ROE, to the 5.95 percent growth estimate using dividends per share. The AG averaged these four

70 Id.

71 Testimony of Dr. Richard L. Wallace, page 54.

methods to arrive at a growth estimate in the range of 4.50 to 5.00 percent.

The Commission has traditionally used the DCF model in estimating ROE. Although one cannot rely on a strict interpretation of the DCF model, the Commission finds that the DCF approach based on dividend growth will provide the best estimate of an investor's expected ROE. The Commission finds that the historical, compound growth rate of 6.35 percent estimated by Western overstates the growth rate of dividends expected in the future. The Commission also finds that the evidence of record does not support an adjustment to Western's ROE of 1.0 to 1.5 percent for special risk factors. All companies have certain risk characteristics which differentiate them from other enterprises, and the evidence in this case is not persuasive that Western/Atmos's risk profile is so unique as to require an additional return beyond that allowed herein.

The Commission, having considered all of the evidence, including current economic conditions, finds that the cost of common equity is within a range of 12.0 to 13.0 percent. Within this range an ROE of 12.50 percent will best allow Western to attract capital at a reasonable cost, maintain its financial integrity to ensure continued service, provide for necessary expansion to meet future requirements, and also result in the lowest possible cost to ratepayers.

Rate of Return Summary

Applying rates of 10.31 percent for long-term debt, 10.03 percent for short-term debt, and 12.50 percent for common equity to the recommended capital structure approved herein produces an overall cost of capital of 11.20 percent. The Commission finds this overall cost of capital to be fair, just, and reasonable.

REVENUE REQUIREMENTS

Based upon the Commission's findings and determinations, Western requires an increase in revenues of $1,018,455, determined as follows:

Net Investment Rate Base	$63,401,818
Rate of Return	11.20%
Required Net Operating Income	7,101,004
Adjusted Net Operating Income	6,484,278
Deficiency	616,725
Tax Factor	.60555
Increase Required	$ 1,018,455

OTHER ISSUES

Cost-of-Service Study

Western presented a fully allocated embedded class cost-of-service study for the purpose of distributing revenue requirements among rate classes and determining rates of return on rate base at present and proposed rates for the following rate classes: Residential, Commercial, Firm Industrial (G-1 Industrial), Interruptible customers using less than 200,000 Mcf per year (G-2 Interruptible), and Interruptible customers using over 200,000 Mcf per year (G-3 Interruptible). Western stated that these rate classes follow its current rate design and differ from one another in key load characteristics, such as annual use per customer, seasonality of use, and load factor.[72] In

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[72] Prepared Testimony of Thomas H. Petersen, page 6.

distributing costs to rate classes, Western applied a three step allocation process, described by its witness in the following manner:

> First, costs were distributed among the functions of gas cost, storage, distribution, transmission and production. Second, the costs in each function were further classified by whether they were primarily related to the number of customers served, the amount of the commodity delivered, or the daily demands placed on the system. Finally, each functionalized and classified cost was allocated among customer classes.[73]

Western's cost-of-service study indicates that, at present rates, the Residential and Commercial classes have negative rates of return on rate base of (1.31 percent) and (0.71 percent), respectively. The G-1 Industrial class has a rate of return of 24.28 percent, while the rates of return for the G-2 and G-3 Interruptible classes are shown to be 33.6 percent and 37.24 percent, respectively. Overall system rate of return at present rates is 5.77 percent. At proposed rates, the differences between class rates of return are substantially reduced. Class rates of return at proposed rates are as follows: 12.02 percent for Residential, 9.3 percent for Commercial, 18.95 percent for G-1 Industrial, 17.26 percent for G-2 Interruptible, and 17.34 percent for G-3 Interruptible. Overall system rate of return at proposed rates is 12.5 percent.

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73 Id., page 7.

Western stated that its present cost-of-service methodology differs from that filed in Case No. 9556[74] in two significant ways.[75] First, a zero-intercept method was used to classify distribution mains into customer and demand components instead of a minimum system method. Second, pipeline demand costs were allocated to interruptible and firm customers based on an average and peak demand method, instead of by class demands on design day with curtailment.

The Commission believes that the zero-intercept methodology is a more acceptable way to divide distribution main costs into demand-related and customer-related components than the minimum system method. Moreover, the Commission is convinced that the zero-intercept method, which utilizes regression analysis to determine the average unit cost of a theoretical zero diameter main, is statistically and theoretically sound and less subjective than the minimum system method, in which a "minimum" size main must arbitrarily be chosen in order to determine the customer-related component. The Commission, therefore, finds that this modification to Western's cost-of-service methodology is acceptable.

In Case No. 9556, the Commission recommended that Western include, in subsequent cost-of-service studies, alternative

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74 Case No. 9556, Rate Adjustment of Western Kentucky Gas Company On Notice.

75 Prepared Testimony of Thomas H. Petersen, pages 8-9.

methods of cost allocation, such as the peak and average method.[76] This allocation methodology considers volume of use, in addition to peak demand, in determining class responsibility of certain demand-related costs. Use of this methodology by Western in its present cost-of-service study specifically addresses the Commission's concern, as expressed in Administrative Case No. 297[77], regarding cost-of-service methodologies that allocate costs based entirely on maximum design day. The Commission, in that proceeding, stated that cost-of-service methodologies should give some consideration to volume of use.[78] The Commission, therefore, finds that Western's allocation of pipeline demand charges based on an average and peak methodology is acceptable.

KIUC supports Western's cost-of-service study and its rate llocation implications.[79] KIUC's evidence underscored that the average and peak methodology is inappropriate for the allocation of Western's pipeline demand and transmission plant costs, because the method penalizes efficient consumption and encourages system under-utilization. Furthermore, according to KIUC, demand-related costs are unrelated to average demand.[30] KIUC recommends that the

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76 Case No. 9556, Order dated October 31, 1986, page 32.

77 Administrative Case No. 297, An Investigation of the Impact of Federal Policy on Natural Gas to Kentucky Consumers and Suppliers, Order dated September 30, 1986, page 47.

78 Id.

79 Brief of KIUC, page 1.

80 Prefiled Testimony of Kenneth Eisdorfer, page 13.

Commission order Western to file a cost-of-service study in its next rate case that does not utilize the average and peak methodology for the allocation of transmission plant and demand-related purchased gas cost.[81] The Commission will not order Western to file a cost-of-service study which excludes an average and peak allocation methodology since, in fact, it was Commission directives in Administrative Case No. 297 and Case No. 9556 that prompted Western to utilize such a methodology in its present cost-of-service study. However, the Commission encourages all utility companies and intervenors to file well researched and documented alternative and multiple-methodology cost-of-service studies in all future rate proceedings. In Case No. 10201,[82] the Commission stated that a well documented and separated multiple-methodology approach to cost-of-service studies will provide it additional information for rate design. The Commission continues to believe that such an approach to cost-of-service studies is appropriate and beneficial.

Southwire contends that Western's cost-of-service study is biased toward overstating the cost of serving industrial and interruptible classes of customers.[83] In the opinion of

81 Brief of KIUC, page 13.

82 Case No. 10201, An Adjustment of Rates of Columbia Gas of Kentucky, Inc., Order dated October 21, 1988, page 54.

83 Brief of Southwire, page 4.

Southwire, this bias is introduced into Western's cost-of-service study by the zero-intercept estimation which allocated more of the costs of distribution mains to the industrial classes than would a minimum system method.[84] Notwithstanding those arguments, Southwire stated that Western's study, being the only cost-of-service study presented, resulted in a fair, just, and reasonable rate design.[85]

Like Southwire, Logan asserts that Western's use of a zero-intercept methodology in its cost-of-service study, instead of the minimum system method, biased the results of the study in favor of the residential class of customers.[86] Nevertheless, Logan believes that Western's study accurately and appropriately functionalizes, classifies, and allocates Western's costs among the rate classes it serves.[87]

The AG contends that Western's cost-of-service study is flawed since Western incorrectly allocated a portion of storage plant costs based on peak demand allocators instead of a volume-based allocator.[88] The AG asserts that, since Western's

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84 Id.

85 Id., page 5.

86 Brief of Logan, pages 8-9.

87 Id., page 10.

88 Prefiled Testimony of Michael F. Sheehan, page 25.

storage plant is used for "financial purposes" and not for peaking purposes, allocation should have been based on volume.[89] Similarly, KLS criticizes Western's cost-of-service study because it did not allocate pipeline demand charges based entirely on annual volumes.[90]

Western has presented the only complete cost-of-service study in this proceeding. Whereas all intervenors are critical of certain elements of Western's study, only the AG and KLS found it unacceptable as a guide in the design of rates in this case. None of the intervenors, however, presented alternative studies supporting their views. Based on its review of the record pertaining to Western's cost-of-service study, the Commission finds that Western's study is responsive to its concerns as expressed in Administrative Case No. 297 and Case No. 9556 and is reasonable and acceptable as a starting point for rate design.

<u>Revenue Allocation</u>

Western's revenue allocation proposal consists of two parts: (1) a reallocation of pipeline demand charges between firm and interruptible customers, and (2) a shift in the recovery of non-gas costs from interruptible to firm customers. Western based its revenue allocation on its class cost-of-service study as previously discussed.

The allocation of pipeline demand charges as proposed by Western would shift approximately $2.2 million in costs from

89 Brief of the AG, page 40.

90 Brief of KLS, page 5.

interruptible customers to firm customers. Western's proposal is based on an average and peak demand allocator, which recognizes the relationship between average (annual) volumes of 41.6 million Mcf and annualized peak (design day) volumes of 98.5 million Mcf. The resulting ratio of 42.2 percent is multiplied by Western's pipeline demand charges to arrive at the portion of demand charges to be spread over all volumes. The remaining 57.8 percent of pipeline demand charges would be spread over Western's firm volumes of 26.1 million Mcf.

Of its requested increase in base rate revenues of approximately $9 million, Western proposed increases of $9.5 million for firm service customers and decreases of $.5 million for interruptible customers. This proposal reflected Western's cost-of-service study and gave recognition to competition from other fuels and the economic risks of bypass by industrial customers. The proposed allocation produced increases of 17.2 percent for residential customers and 11 percent for commercial customers with a 15.7 percent decrease for industrial customers.

KIUC, Southwire, and Logan generally supported Western's proposed revenue allocation as an appropriate step in the direction of cost-based rates, although all the industrial intervenors recommended a greater reduction in industrial rates than the reduction proposed by Western. KIUC cited biases in Western's cost-of-service study that it claimed tend to overstate the level of costs allocated to the industrial rate classes.[91]

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91 Prepared Testimony of Kenneth Eisdorfer, pages 12-17.

The AG and KLS both argued that Western's cost-of-service study was flawed and that Western's rate proposals for industrial customers reflect competitive pricing rather than cost-of-service pricing. The AG argued that the industrial class, with its demonstrated ability to use alternate fuels and/or bypass Western, poses a greater risk to Western than its other customers and that such risk should be reflected in Western's cost allocation and rate design.[92]

In one fashion or another, Western and the intervenors recognize the concept of rates based on fully allocated costs. However, beyond such recognition, there is little agreement as to the proper determination of fully allocated costs and how such costs should be reflected in the allocation of Western's revenues. The Commission is aware that various criticisms have been directed at Western's cost-of-service study as the basis for designing rates; however, the study was responsive to the Commission's Orders in Western's last rate case, Case No. 9556 and Administrative Case No. 297. It is with the directives of those Orders in mind that the Commission has evaluated Western's revenue allocation.

In making its evaluation the Commission recognizes that the natural gas industry has undergone major changes in recent years. Those changes began with federal legislation in the late 1970s which provided for the removal of many of the controls on the

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92 Prepared Testimony of Michael F. Sheehan, pages 13-17.

wellhead price of gas. Those changes have continued through the 1980s with federal regulatory decisions that permit end-users to arrange for their own gas supplies and use the local distribution company ("LDC") as a transporter of those supplies. Federal regulatory decisions have also permitted end-users to bypass the LDC and take service directly from a pipeline supplier.

As a result of these actions, large volume end-users, mainly industrial customers, have sought out their own gas supplies at prices less than the LDC's price for its system supply gas. These industrial customers have also argued that absent cost-based transportation rates from the LDCs, those customers will bypass with the result being loss of load and loss of revenues for the LDC.

These circumstances represent a significant departure from the time when all customers were essentially captive and there was little incentive for companies or regulators to consider costs as a major factor in allocating revenues and designing rates. The results of regulation in this "pre-cost" era were that services were often priced at less than the cost of service to residential customers and priced at more than the cost of service to commercial and industrial customers. Conventional wisdom held that because commercial and industrial customers could pass along price increases to their customers it was more palatable to over-price services to those customers while under-pricing services to residential customers.

It is these past circumstances and practices that have contributed to the allocation and rate issues presented in this case. The Commission recognizes these to be serious issues which require reasoned and deliberate analysis that considers the conditions existing in today's competitive environment as well as the rate impact on Western's captive customers. While recognizing that its decision may not be popular with those captive customers, the Commission believes that a restructuring of Western's rates is necessary as explained in the following paragraphs.

The most significant aspect of Western's rate restructuring is its proposed allocation of pipeline demand charges for recovery through its gas cost adjustment clause. The Commission finds that the average and peak allocator utilized by Western reflects both average volumes and design day volumes in the allocation of costs and recognizes the differing characteristics of firm and interruptible loads. It addresses the Commission's concern, expressed in Administrative Case No. 297 that companies consider the possible de-averaging of the costs of gas and how to assign those costs by customer class. Furthermore, it is responsive to the Commission's Order in Case No. 9556 which specifically recommended that Western evaluate alternative methods of cost allocation such as the average and peak method. Therefore, the Commission concludes that Western's proposed allocation of pipeline demand charges is reasonable and equitable and should be approved. The Commission also finds that the allocation of pipeline demand charges should be updated annually as part of Western's first gas cost adjustment filing following the development of its design day plan.

The second part of Western's rate restructuring involves the allocation of non-gas, or base rate revenues. The Commission finds that the firm customer classes, at present rates, are not making an adequate contribution to Western's overall rate of return and that, in order to increase that contribution, the full amount of the increase granted herein should be allocated to those customer classes.

The Commission also finds that none of the increase granted herein should be allocated to Western's interruptible classes but rather that the base rate revenue contribution of the interruptible classes should remain unchanged. The Commission concurs with the AG that Western's interruptible customers, with their non-captive status, impose a greater level of risk on Western than do its firm, essentially captive customers. The Commission finds that such risk translates into higher rates of return, which Western attempted to reflect in its cost-of-service study. The Commission has previously made similar findings regarding the risks associated with serving non-captive industrial customers in Case No. 10498.[93]

The Commission finds that maintaining the test-year base rate revenue contribution for the interruptible rate classes recognizes the greater risks attendant with serving these classes and follows the moderate, gradual course of action for rate restructuring

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93 Case No. 10498, Adjustment of Rates of Columbia Gas of Kentucky, Inc., Order dated October 6, 1989, pages 48-49.

outlined by the Commission in Administrative Case No. 297.[94] As this is Western's first rate case since Administrative Case No. 297, the Commission, contrary to KIUC's arguments, concludes that gradualism should be recognized in the allocation of revenues. While Western contends that gradualism was considered in preparing its case, the requested increases and the proposed class rates of return reflect major revenue shifts with little regard to gradualism or rate continuity.

Maintaining the same interruptible revenue levels while pricing some of its contract volumes at tariffed rates will have the impact of reducing Western's interruptible rates. In conjunction with the reallocation of pipeline demand charges, this approach results in a significant restructuring of Western's rates.

Rate Design

Western proposed to double the customer charges for residential and non-residential firm customers to $6 and $16, respectively, and, for the first time, to impose a customer charge on interruptible customers. The interruptible customer charge would match the $16 charge for non-residential firm customers. Western proposed to combine Interruptible Rate Schedules G-2 and G-3 and to change from a flat rate to a declining block rate structure for all rate schedules. For firm customers on Rate Schedule G-1, the first block of 300 Mcf would be priced 62.6

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94 Order dated September 30, 1986, page 40.

cents above the second block of 14,700 Mcf, which in turn, would be priced 20 cents above the last block for sales above 15,000 Mcf. For interruptible customers on the combined Schedule G-2, the first block of 15,000 Mcf would be priced 20 cents above the second and, last, block for everything over 15,000 Mcf. Western indicated that the 15,000 Mcf break point and related 20 cents rate differential were based on its cost-of-service study with the intent of making the firm and interruptible schedules more compatible. Western also indicated that the first block of 300 Mcf on the G-1 Schedule was designed to capture all residential and most small commercial volumes at the higher rate in order to improve the rates of return for the residential and commercial classes.

The AG contends that the G-1 rate design proposed by Western for firm customers discourages conservation and places a disproportionate share of fixed cost recovery on low volume customers. The AG recommended a rate design with a smaller customer charge and a flat block, or flatter, declining block rate structure for firm volume customers.

The AG recommended that for interruptible customers Western should recover a much larger portion of fixed costs through the customer charge and first block than had been proposed. The AG maintains that such an approach would make fixed cost recovery less uncertain and would be consistent with Western's rate proposals for firm service customers.

The proposal to combine schedules G-2 and G-3 with one resulting G-2 rate schedule for interruptible customers equitably reflects Western's cost of service and is acceptable. The Commission finds Western's objective in proposing a declining block rate structure is supported by the cost-of-service study and the proposed rate blocks for G-1 and G-2 appear to be reasonable; however, in consideration of the concerns expressed by the AG and in keeping with its goals of moderation, gradualism, and rate continuity, the Commission will set rates that reflect only a 15-cent differential between blocks. Western's proposed customer charges for firm customers have also been rolled back to $3.50 and $9.35 based on the amount of the increase granted herein.

Western proposed a customer charge for interruptible customers and set it at the $16 level proposed for firm non-residential customers. The $16 charge was proposed even though Western's calculation of its G-2/G-3 monthly customer costs ranged from $344 to $1,544. The AG's evidence argues for a larger, up-front charge as a means of recovering a larger proportion of fixed costs from these customers.[95] The Commission finds that a larger fixed charge would better reflect Western's cost of service and would result in reduced reliance on sales volumes for the recovery of fixed costs. Therefore, the Commission finds a monthly customer charge or base charge of $100 per delivery point for rates G-2 and T-3 to be reasonable as another component in the restructuring of Western's rates to better reflect its cost of service. Customers that take both firm

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95 Prepared Testimony of Michael F. Sheehan, page 16.

volumes and interruptible volumes should be billed as interruptible customers for purposes of determining the customer charge.

The rates set out in the Appendix will produce the additional revenues granted herein. The rate changes, by customer class, produce increases of 6.2 percent and 5.2 percent, respectively, for residential and commercial customers, and a decrease of 8.0 percent for industrial customers. These percentage changes do not reflect the decrease in Western's commodity gas costs since the filing of this case.

Carriage Service

In compliance with the Commission's Order in Administrative Case No. 297, Western proposed a carriage (transportation) rate which excludes standby service. The proposed transportation rate, Rate T-3, recovers Western's simple margin applicable to interruptible service and includes those non-commodity gas costs related to take-or-pay recovery.

KIUC maintains that Rate T-3 should not be based on Western's simple margin as it includes costs related to gas stored underground and production plant. Western's proposal, which is similar to the carriage and transportation rates the Commission has approved for other companies, recognizes that establishing a smaller margin for carriage service could negatively impact earnings if substantial loads switched from Western's existing transportation service to carriage service.

Western's proposal to base its carriage rate on its simple margin applicable to interruptible service is reasonable and sound from both a rate-making and economic perspective. The Commission, therefore, accepts this proposal and authorizes Western to provide carriage service based on the simple margin established in this case.

Energy Assurance Program

KLS proposed that Western implement an energy assurance program ("EAP") to assist low-income customers in paying their gas bills and to improve Western's ability to collect from those customers.[96] KLS contends that Western's traditional collection mechanisms are not producing the maximum revenue stream possible from low-income customers which, in turn, results in additional costs being born by all ratepayers.

Under the EAP, households living at or below 150 percent of the federal poverty level with an annual energy bill that exceeds 6 percent of the household's income would make payments toward its current bill equal to 6 percent of its monthly income. Each household would be required to also make a monthly payment of $3 for 36 months toward reducing its existing arrearages; Western would be required to write-off any arrearages in excess of the total of $108 paid by the participant household. These households would also be targeted for education and energy conservation programs to encourage reduced energy use.

KLS estimated that Western could implement this program at virtually no cost and increase the revenues collected from its

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96 Prepared Testimony of Roger D. Colton, pages 9-15.

low-income customers. It is KLS' opinion that the provisions of the EAP do not conflict with either the statutes or the administrative regulations governing utility regulation in the Commonwealth of Kentucky.[97] KLS also stated that the EAP represents a collection issue and not a rate issue.[98]

The Commission has concerns about the accuracy of the predicted costs and cost savings of the EAP and questions whether such a program should be imposed on a company absent a detailed company-specific analysis. More importantly, contrary to the opinion of KLS, the Commission considers some aspects of the EAP to represent a rate issue which does not comport with Kentucky statutes 278.160 and 278.170. These statutes prohibit a utility from (1) giving any unreasonable rate preference or advantage to any customer and (2) charging or receiving any less compensation that what is prescribed in its filed rate schedules. Under the EAP, Western would be charging less than the amount prescribed in its rate schedules and would, particularly in instances where the fixed payment based on a percentage of income would not recover variable costs, be giving an unreasonable preference to these customers. Therefore, the Commission finds that the EAP proposed by KLS cannot be imposed on Western as such program does not comply with Kentucky statutes.

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97 T.E., Vol. III, pages 73 and 74.

98 Id., pages 52-53.

In addition to the statutory prohibition, the Commission is concerned about the degree to which the EAP would place a utility in the position of administering a social program. While the Commission recognizes that a number of customers in the low-income category have difficulty paying their utility bills, the notion of a Commission-approved subsidy program is not the answer. The Commission believes that government-sponsored programs such as LIHEAP should be utilized to the fullest extent possible, with the emphasis on government-sponsored programs, as opposed to utility/ratepayer-sponsored programs.

Standard Contract Form

As part of its application Western submitted a proposed service agreement with the heading "Large Volume Natural Gas Service Contract." Western's legal counsel stated that it was Western's intent that the standard contract form be approved to be filed as part of its tariffs. Western indicated that, with Commission approval of the standard contract form, it would intend that the general terms and conditions set forth in the contract would be applicable to all new contract customers and that the standard contract would be offered to those customers for their acceptance.

The Commission is concerned that a standard contract form might be too restrictive for some circumstances and could limit the flexibility of both Western and its customers. While the general terms and conditions appear to be reasonable, the Commission would prefer to review separately the merits of each individual contract, thereby giving all parties, including the

Commission, greater latitude in the area of customer service contracts. Therefore, the proposed standard contract form will not be approved to be included as part of Western's tariffs.

Tariff Changes

Western's proposed tariffs reflected its changes in rate design, the combining of rates G-2 and G-3, the proposed carriage service, and the changes in its gas cost adjustment clause resulting from its proposed allocation of pipeline demand charges. In addition, Western proposed several minor text changes in its tariffs which have not specifically been addressed herein. The major tariff changes or additions as approved by the Commission are shown in the Appendix to this Order. Any minor text changes not specifically shown in the Appendix are approved as proposed by Western.

SUMMARY

After consideration of all matters of record, the evidence, and being otherwise sufficiently advised, the Commission finds the following:

1. The rates in the Appendix, which is attached hereto and incorporated herein, are the fair, just, and reasonable rates for Western to charge its customers for service rendered on and after the date of this Order.

2. The rates proposed by Western would produce revenue in excess of that found reasonable herein and should be denied.

3. The rate of return granted herein is fair, just, and reasonable and will provide for the financial obligations of Western with a reasonable amount remaining for equity growth.

4. The tariff changes set forth in the Appendix are reasonable and should be approved.

IT IS THEREFORE ORDERED that:

1. The rates in the Appendix are approved for services rendered by Western on and after the date of this Order.

2. The rates proposed by Western are hereby denied.

3. The text changes authorized herein and the tariffs set forth in the Appendix are hereby approved.

4. Within 30 days of the date of this Order, Western shall file with the Commission revised tariffs sheets setting out the rates and tariff provisions approved herein.

Done at Frankfort, Kentucky, this 13th day of September, 1990.

PUBLIC SERVICE COMMISSION

Chairman

Robert M. Davis
Vice Chairman

Commissioner

ATTEST:

Executive Director

APPENDIX

APPENDIX TO AN ORDER OF THE KENTUCKY PUBLIC SERVICE COMMISSION IN CASE NO. 90-013 DATED 9/13/90

The following rates and charges are prescribed for the customers in the area served by Western Kentucky Gas Company. All other rates and charges not specifically mentioned herein shall remain the same as those in effect under authority of this Commission prior to the effective date of this Order. These rates reflect all gas cost adjustments through Case No. 9556-O.

GENERAL SALES SERVICE RATE G-1

Rate - Net:

Base Charge:	$3.50	per meter per month for residential service
	$9.35	per meter per month for non-residential service

Commodity Charge:

First 300 Mcf per month	$4.3435	per 1,000 cubic feet
Next 14,700 Mcf per month	$4.1935	per 1,000 cubic feet
Over 15,000 Mcf per month	$4.0435	per 1,000 cubic feet

All gas consumed by the customer (sales, transportation, firm and interruptible) will be considered for the purpose of determining whether the volume requirement of 15,000 Mcf has been achieved.

INTERRUPTIBLE SALES SERVICE RATE G-2

Rate - Net:

Base Charge:	$100.00	per delivery point per month

Interruptible Service:

Gas used per month in excess of the high priority service shall be billed as follows:

First 15,000 Mcf per month	$3.6546	per 1,000 cubic feet
All over 15,000 Mcf per month	$3.5046	per 1,000 cubic feet

All gas consumed by the customer (sales, transportation, firm and interruptible) will be considered for the purpose of determining whether the volume requirement of 15,000 Mcf has been achieved.

GENERAL TRANSPORTATION TARIFF RATE T-2

Rate:

In addition to any and all charges assessed by other parties, there will be applied a Gross Margin Transportation Rate which shall be:

A. The Simple Margin as being the difference between the otherwise applicable Sales Tariff Rate and the Base Cost of Gas (BCOG), fixed at $3.4344, for firm service and $3.1771 for interruptible service as approved by the Company's most recent rate Order, Case No. 90-013, plus

B. The Non-Commodity Components as calculated in the Company's most recent Quarterly Gas Cost Adjustment (GCA) filing.

Special Provisions:

A. Service under this rate schedule entitles the customer to purchase sales gas from the Company at the applicable tariff rates when its supply requirements exceed the nominated volume. The customer is entitled to purchase natural gas from the Company consistent with the applicable Sales Rate Schedule.

CARRIAGE SERVICE TARIFF RATE T-3

Applicable:

Entire service area of the Company to any customer for that portion of the customer's interruptible requirements not included under one of the Company's sales tariffs.

Availability of Service:

A. Available to any customer with a daily nominated volume (see Definition, Section 4) which averages a minimum of 100 Mcf of gas per day for the billing period on an individual service at the same premise which has purchased its own supply of natural gas and requires carriage by the Company to the point of utilization, subject to suitable service being available from existing facilities. (See Section 7 if additional facilities are necessary.)

B. The Company may decline to initiate service to a customer under this tariff or to allow a customer receiving service under this tariff to elect any other service provided by the Company, if in the Company's sole judgment, the performance of such service would be contrary to good operating practice or would have a detrimental impact on other customers serviced by the Company.

Rate:

Monthly Base Charge: $100.00 per delivery point

Minimum Charge: The Base Charge

In addition to any and all charges assessed by other parties, there will be applied a Carriage Service Commodity Rate consisting of:

A. The Simple Margin applicable to interruptible service, as approved in the Company's most recent rate Order, Case No. 90-013, plus

B. Any applicable non-commodity components as approved in the Company's most recent Gas Cost Adjustment (GCA) filing.

Carriage Service Commodity Rates are stated at PSC No. 19, Sheet No. 17.

Nominated Volume:

Definition: "Nominated Volume" or "Nomination" - The level of daily usage in MMbtu (to be converted to Mcf for billing purposes) as requested by the customer to be carried by the Company.

Such nomination request (nomination form plus required offers of credit and/or waivers or any other data required) shall be made by the customer or its agent to the Company on a monthly basis a minimum of ten (10) working days prior to commencement of the billing period. Such nomination may be adjusted prospectively from time to time during the billing period as may become necessary. However, the Company retains the right to limit the number of nomination adjustments during the billing period.

Curtailment:

A. The Company shall have the right at any time, without liability to the customer, to curtail or to discontinue the delivery of gas entirely to the customer for any period of time when such curtailment or discontinuance is necessary to protect the requirements of domestic and commercial customers; to avoid an increased maximum daily demand in the Company's gas purchases; to avoid excessive peak load and demands upon the gas transmission or distribution system; to relieve system capacity constraints; to comply with any restriction or curtailment of any governmental agency having jurisdiction over the Company or its supplier or to comply with any restriction or curtailment as may be imposed by the Company's supplier; to protect and insure the operation of the Company's underground storage system; for any causes due to force majeure (which includes acts of God; strikes, lockouts, civil commotion, riots, epidemics, landslides, lightning, earthquakes, fires, storms, floods, etc.); and for any other necessary or expedient reason at the discretion of the Company.

B. All curtailments or interruptions shall be in accordance with and subject to the Company's "Curtailment Order" as contained in Section 29 of its Rules and Regulations as filed with and approved by the Public Service Commission.

Measurement:

The unit of measurement shall be a Mcf at a pressure base of 14.65 psia, a temperature of 60 degrees Fahrenheit and 0.60 specific gravity.

Special Provisions:

It will be the responsibility of the customer to pay all costs for additional facilities and/or equipment which may be required as a result of receiving service under this Carriage Service Rate T-3.

A written contract with maximum daily and monthly carriage volumes and with a minimum term of one year shall be required.

No gas delivered under this rate schedule and applicable contract shall be available for resale.

Terms and Conditions:

A. Specific details relating to volume, delivery point/meter number and similar matters shall be covered by a separate written contract or amendment with the customer.

B. The Company will not be obligated to deliver a total supply of gas to the customer in excess of the customer's maximum daily carriage volumes. The Company has no obligation under this tariff to provide any sales gas to the customers.

C. It shall be the customer's responsibility to make all necessary arrangements, including obtaining any regulatory approval required, to deliver gas under this Carriage Service Rate to the facilities of the Company.

D. The Company reserves the right to refuse to accept gas that does not meet the Company's quality specifications.

E. The Rules and Regulations and Orders of the Kentucky Public Service Commission and of the Company and the Company's General Terms and Conditions applicable to the Company's Sales Tariff Rates shall likewise apply to these Carriage Service Rates and all contracts and amendments thereunder.

F. The customer must provide the Company a minimum 24 hour advance notice of any change in the status of the customer's gas supply or gas usage during the month. In the event the customer loses its gas supply, it will be allowed two working days in which to secure replacement volumes (up to the maximum daily carriage quantity) and resubmit its nomination to the Company. This volume will be subject to the provisions of Section G if not made up by the end of the month.

G. Volumes taken by the customer in excess of carriage volumes available for delivery by the Company in a month shall be deemed as overrun and will be billed at $10.00 per Mcf.

H. In the event a customer fails in part or in whole to comply with a Company curtailment order either as to time or volume of gas used or uses a greater quantity of gas than its daily carriage demand or a quantity in excess of any temporary authorization whether a curtailment order is in effect or not, the customer shall pay for the unauthorized gas so used at the rate of $15.00 per Mcf. Billing of this penalty shall be made within 90 days of the date of violation and shall be due and payable within 20 days of billing.

The payment of penalty charges shall not be considered as giving any customer the right to take unauthorized volumes of gas nor shall such penalty charges be considered as a substitute for any other remedy available to the Company.

I. The customer will be solely responsible to correct, or cause to be corrected, any imbalances it has caused on the applicable pipeline's system.

Late Payment Charge:

Should any customer fail to pay all of the amount of any bill within ten (10) days after such bill is rendered, interest on the unpaid portion of the bill shall accrue, at the then effective prime interest rate (Citizens Fidelity Bank and Trust Company, Louisville, Kentucky) from the due date, until the date of payment.

TRANSPORTATION RATE T-2 AND CARRIAGE RATE T-3

The General Transportation Tariff Rate T-2 and Carriage Service Rate T-3 for each respective service rate is as follows:

Transportation Service Rate T-2

Includes standby sales service under corresponding sales rates.

General Service Rate G-1:

	Simple Margin	+	Non-Commodity Components	=	Gross Margin Transportation Rate Per 1,000 Cu. Ft.
First 300 Mcf/mo.	$0.9091		0.4151		$1.3242
Next 14,700 Mcf/mo.	0.7591		0.4151		1.1742
All over 15,000 Mcf/mo.	0.6091		0.4151		1.0242

Interruptible Service Rate G-2:

	Simple Margin	+	Non-Commodity Components	=	Gross Margin Transportation Rate Per 1,000 Cu. Ft.
First 15,000 Mcf/mo.	$0.4775		0.1573		$0.6348
All over 15,000 Mcf/mo.	0.3275		0.1573		0.4848

Carriage Service Rate T-3:

Excludes standby sales service.

	Simple Margin	+	Non-Commodity Components	=	Gross Margin Transportation Rate Per 1,000 Cu. Ft.
First 15,000 Mcf/mo.	$0.4775		0.0358		$0.5133
All over 15,000 Mcf/mo.	0.3275		0.0358		0.3633

GAS COST ADJUSTMENT CLAUSE

BCOG is the base cost of gas per 1,00 cubic feet:

Firm Service (Rate G-1)	$3.4344	per 1,000 cubic feet
Interruptible Service (Rate G-2)	$3.1771	per 1,000 cubic feet

Applicable to: All Service Rate Schedules

	Firm	Interruptible
Gas Cost Adjustment (GCA) per 1,000 cubic feet	$(0.5919)	$(0.5924)
Refund Adjustment (RF) per 1,000 cubic feet	0.0000	0.0000
Net GCA Factor per 1,000 cubic feet	(0.5919)	(0.5924)

Derivation of above adjustments:

Gas Cost Adjustment (GCA)	Firm	Interruptible
Expected Gas Cost Component (EGC)	$ 2.9763	$ 2.7185
Less: Base Cost of Gas (BCOG)	3.4344	3.1771
Gas Cost Component (EGC minus BCOG)	(0.4581)	(0.4586)
Gas Cost Actual Adjustment (GCAA)	(0.0443)	(0.0443)
Gas Cost Balance Adjustment (GCBA)	(0.0895)	(0.0895)
Sub-Total	$(0.5919)	$(0.5924)

Refund Adjustment (RF)

Refund factors continuing for 12 months from the effective date of each refund filing:

Refund effective 5/1/89 Case No. 9556-J	\$(0.0000)	\$(0.0000)
Total Refund Factor (RF)	(0.0000)	(0.0000)
Net GCA Factor per 1,000 feet	\$(0.5919)	\$(0.5924)